

**LEGISLATIVE SERVICES AGENCY  
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS**

301 State House  
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**FISCAL IMPACT STATEMENT**

**LS 6049**

**BILL NUMBER:** SB 321

**DATE PREPARED:** Nov 7, 2001

**BILL AMENDED:**

**SUBJECT:** Taxation of Federal Retiree Benefits.

**FISCAL ANALYST:** Jim Landers

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**FUNDS AFFECTED:** X **GENERAL**  
**DEDICATED**  
**FEDERAL**

**IMPACT:** State & Local

**Summary of Legislation:** The bill provides an Adjusted Gross Income Tax deduction for the part of a federal government pension (including a military pension) equal to the difference between: (1) the maximum benefits payable under Social Security that could have been excluded from federal gross income for the year; minus (2) the Social Security benefits actually received by the taxpayer during the year. The bill also provides that a taxpayer may not claim both this deduction and the existing military service deduction or federal civil service deduction.

**Effective Date:** January 1, 2003.

**Explanation of State Expenditures:** The Department of State Revenue (DOR) will incur some administrative expenses related to the revision of tax forms, instructions, and computer programs to incorporate this deduction. These expenses presumably can be absorbed given the DOR's existing budget and resources.

**Explanation of State Revenues:** If all civil service and military pension income not already claimed under current deductions is deducted under the provisions of the bill, it would result in a net reduction in income tax revenue totaling as much as \$30.9 M in FY 2004. However, the actual fiscal impact of the bill could potentially be reduced to the extent that taxpayers (or their spouses) receive Social Security benefits. In addition, the fiscal impact could be further reduced to the extent that taxpayers' pension income exceeds the maximum amount of benefits payable under Social Security that may be excluded from federal gross income.

**Background:** This bill provides an Individual AGI Tax deduction for recipients of federal civil service pensions and military pensions beginning in tax year 2003. The bill permits a taxpayer to deduct the amount of civil service or military pension benefits included in the taxpayer's federal AGI. However, the deduction may not exceed: (1) the amount of civil service or military benefits received by the taxpayer that would have

been tax-exempt if they had been treated as Social Security benefits; minus (2) the amount of Social Security benefits actually received by the taxpayer that are tax-exempt. The bill prohibits a taxpayer from claiming both the deduction established under the bill *and* the existing military service deduction or federal civil service annuity deduction.

The typical maximum excludable Social Security benefit for taxpayers who receive income from military or civil service pensions is indeterminable. In addition, no data is available which indicates the Social Security benefit typically obtained by individuals who receive income from military or civil service pensions. As a result, the estimated impact assumes that all income from military and civil service pensions would be deducted under the bill. The estimate also nets out the cost of the current \$2,000 deductions for civil service annuities and military retirement benefits.

*Civil service annuities:* Under current statute, taxpayers may deduct up to \$2,000 in civil service annuity income. DOR data indicates that 4,474 taxpayers claimed this deduction in 1999 and deducted approximately \$7.9 M in civil service annuity pay. Recently, this deduction has been declining on average by about 2.8% per year. Thus, the 2003 deduction amount is estimated at about \$7.1 M. According to the Federal Office of Personnel Management, there are currently 24,914 federal retirees and 8,908 surviving spouses residing in Indiana. These individuals will receive civil service annuity payments totaling approximately \$598.4 M during 2001. Assuming growth rates in annuity payments of 2.6% in 2002 (the established COLA) and 3.2% in 2003 (the observed rate of growth in recent years), annuity payments are estimated to total about \$633.4 M in 2003. Thus, if all civil service annuity income not claimed under the existing civil service annuity deduction (an estimated \$626.3 M in 2003) is deducted from state taxable income in 2003, the corresponding revenue loss in FY 2004 is estimated to be approximately \$21.3 M.

*Military retirement benefits:* Under current statute, a taxpayer may deduct up to \$2,000 in military service income. This deduction applies to all types of military service income, including retirement benefits and active duty pay. DOR data indicates approximately \$67.4 M in military service income was deducted from taxable income in 1999, about \$42.7 M of which is estimated to be attributable to military retirees. This is based on the total number of military retirees reported in Indiana in 1999 by the Department of Defense. Given the recent decline in the military service deduction averaging about 2.2% per year, the deduction amount attributable to military retirees is estimated to be about \$39.0 M in 2003. Based on Department of Defense data, the military retirees in Indiana will receive approximately \$304.0 M in taxable retirement pay during 2001. (Some military retirement income is not taxable at the federal level and would not affect Indiana's individual income tax.) Given recent growth rates of 3% per year, taxable retirement pay is estimated to be about \$322.5 M in 2003. Thus, if all military retirement income not claimed under the existing military service deduction (an estimated \$283.4 M in 2003) is deducted from state taxable income in 2003, the corresponding revenue loss in FY 2004 is estimated to be approximately \$9.6 M.

Individual AGI Tax revenue is deposited in the General Fund. As this bill is effective beginning in tax year 2003, the fiscal impact to the state will begin in FY 2004.

**Explanation of Local Expenditures:**

**Explanation of Local Revenues:** Counties imposing local option income taxes (CAGIT, COIT, and/or CEDIT) may experience an indeterminable decrease in revenue from these taxes as a result of this proposal.

**State Agencies Affected:** Department of State Revenue.

**Local Agencies Affected:** Counties imposing local option income taxes.

**Information Sources:** DOR 1999 individual income tax data; Ed Callicott, Federal Office of Personnel Management, (202) 606-1782; Mike Dove, Department of Defense, Manpower Data Center, (408) 583-2400.